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AUDIT PLAN
MLGW - MEMPHIS NETWORKX
AUGUST 2001 - DECEMBER 2002INTRODUCTION

Draft - provided
to ~~ML~~ Ernst &
Young - Aug. 14, 2003
via e-mail
OF

On August 9, 2001, the Tennessee Regulatory Authority ("Authority" or "TRA") issued an order approving the Joint Petition of Memphis Light, Gas & Water Division ("MLGW") and Memphis Broadband, LLC for the creation of and operation of Memphis Networkx, LLC. Further, the Authority granted the application of Memphis Networkx, LLC for a Certificate of Public Convenience and Necessity.

The aforementioned Joint Petition and Certificate were approved on the condition that MLGW and Memphis Networkx would submit to an annual audit conducted by an independent auditor selected by Memphis Networkx to work under the direction and supervision of the Authority. The purpose of the annual audit is to determine whether MLGW and Memphis Networkx are complying with statutory provisions prohibiting cross-subsidization and other specific requirements set forth by the Authority.

PRELIMINARY AUDIT PROCEDURES

Prior to the on-site audit, several items of information should be gathered and/or reviewed.

I. Gather Data/Information:

- A. Financial statements (income statement, balance sheet and statement of cash flows for:
 - 1. MLGW, inclusive of the Telecommunications Division;
 - 2. The Telecommunications Division of MLGW;
 - 3. Memphis Networkx.
- B. Internal audit reports of MLGW for the period of August 2001 to December 2002;
- C. CPA audit reports for MLGW for the period of August 2001 to December 2002;
- D. Chart of accounts for the Telecommunications Division of MLGW;
- E. Name and address of all affiliate divisions;
- F. All written contracts entered into between MLGW and Memphis Networkx;
- G. All written contracts, including loans, entered into between MLGW and its Telecommunications Division; and
- H. Contracts between MLGW and third parties for pole attachment rates and underground installations.

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- II. Review Applicable State Laws and Authority Orders:
 - A. Tenn. Code Ann. §§ 7-52-401 through 7-52-407 and statutes referenced therein; and
 - B. Tennessee Regulatory Authority's August 9, 2001 Order approving Memphis Network franchise.
- III. Review applicable NARUC guidelines and FCC rules:
 - A. National Association of Regulatory Utility Commissioner's "Cost Allocation and Affiliate Transactions Guidelines for the Energy Industry";
 - B. Federal Communication Commission affiliate transaction rules, 47 Code of Federal Regulations § 32.27; and
 - C. Federal Communication Commission cost allocation rules, 47 Code of Federal Regulations §§ 64.901 through 64.904.
- IV. Review MLGW's cost allocation manual.
- V. Review the Operating Agreement between MLGW, Memphis Broadband and Memphis Network.

COMPLIANCE REQUIREMENTS

- I. MLGW and Memphis Network shall not have common employees.
- II. MLGW shall charge to Memphis Network the highest rate for pole attachments and underground installations as it charges third parties under comparable agreements required by Tenn. Code Ann. §7-52-405.
- III. Funds lent to the Telecommunications Division by MLGW shall be lent at a rate of interest not less the highest rate then earned by the MLGW on invested electric plant funds.
- IV. MLGW shall not provide subsidies to Memphis Network as required by Tenn. Code Ann. §7-52-402.
- V. MLGW shall maintain records to comply with:
 - A. National Association of Regulatory Utility Commissioner's "Cost Allocation and Affiliate Transactions Guidelines for the Energy Industry";

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- B. Federal Communication Commission affiliate transaction rules, 47 Code of Federal Regulations § 32.27; and
- C. Federal Communication Commission cost allocation rules, 47 Code of Federal Regulations §§ 64.901 through 64.904.

ENGAGEMENT PLAN

I. Engagement period

The period subject to audit is August 2001 through December 2002.

II. Conditions of Engagement

A. The independent auditor selected is:

John Skelton, Partner
Ernst & Young, LLP
2400 One Commerce Square
Memphis Tennessee 38103
Phone: (901) 577-6319
Fax: (901) 577-6339
Email: john.skelton@ey.com

B. Members of the audit team shall have a sufficient understanding of the following:

1. Tenn. Code Ann. §§ 7-52-401 through 7-52-407 and statutes referenced therein;
2. Tennessee Regulatory Authority's August 9, 2001 Order approving Memphis Network franchise;
3. National Association of Regulatory Utility Commissioner's "Cost Allocation and Affiliate Transactions Guidelines for the Energy Industry";
4. Federal Communication Commission affiliate transaction rules, 47 Code of Federal Regulations § 32.27; and Federal Communication Commission cost allocation rules, 47 Code of Federal Regulations §§ 64.901 through 64.904;
5. MLGW's cost allocation manual; and
6. Operating Agreement between MLGW, Memphis Broadband and Memphis Network.

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- C. Independent auditor selected shall file a written affidavit stating its independence from MLGW and Memphis Networkx.

III. Engagement Process and Timetables

A. The audit plan developed by the TRA will be presented to the independent auditor for review. The auditor will be given thirty (10) days to review the plan, after which the auditor and Staff will meet to discuss the overall plan including any questions, concerns and/or suggestions of the auditor. After taking the auditor's interests into consideration the TRA will present a final audit plan to the independent auditor within fifteen (15) days.

B. During the audit, the independent auditor has discretion to add procedures it deems necessary to ascertain whether the stated objective is being met. These procedures, however, should be provided to the appropriate Authority Staff.

C. Within sixty (45) days after issuance of the final audit plan, but prior to discussing the findings with the Companies (MLGW and Memphis Networkx), the independent auditor shall submit a draft of the report to the TRA Staff. The Staff shall have thirty (20) days to review the findings and workpapers and offer its recommendations, comments and exceptions.

D. If there are additional procedures requested by Staff, the auditor shall inform the Companies of need for additional time to perform such procedures. If no additional procedures are requested, the report, including any appropriate revisions, shall be submitted to the Companies within fifteen (3) days.

E. The Companies shall have thirty (15) days to submit its comments and/or responses to the report to the auditor and TRA Staff.

IV. Report Structure

The auditor shall present the results of performing the audit procedures in the form of findings consistent with AICPA standards. The report shall describe fully all instances of noncompliance with applicable state laws and/or relevant TRA orders. For sampling to test data, the report shall identify the size of the universe, the size of the sample, the sampling methodology and if appropriate, the standard deviation.

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AUDIT OBJECTIVES AND PROCEDURES

OBJECTIVE I. Determine whether existing internal controls and procedures for implementing and complying with statutory and Authority requirements are sufficient.

PROCEDURES

1. Discuss with and obtain from MLGW management all existing internal control procedures for ensuring compliance with statutory requirements such as the prevention of cross-subsidization and proper allocations made by MLGW to its Telecommunications Division.
2. Discuss with and obtain from management all existing internal control procedures for ensuring compliance with specific requirements set forth by the Authority in its August 9, 2001 Order approving the application of Memphis Network, including, but not limited to, the preparation of the annual report and the requirement for separate employees.
3. Obtain from management the employees specifically assigned to perform the duties outlined in procedures 1 and 2 above.
4. Discuss with and obtain from management all existing procedures and methods involved in training and educating employees of statutory and Authority requirements.
5. Report findings.

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OBJECTIVE II. Pursuant to Tenn. Code Ann. § 7-52-405, determine whether MLGW has charged an amount for pole attachments and conduit rental services to Memphis Networkx equal to the highest rate charged by MLGW to any other person or entity for comparable attachments.

PROCEDURES

1. Obtain copies of all pole attachment agreements/contracts that MLGW has in place with other persons or entities and a copy of the annual report filed with the TRA by MLGW and Memphis Networkx for the period August 2001 through December 2002.
2. Review general ledger for amount of pole attachment/conduit costs charged to Memphis Networkx by MLGW and verify the amount with the amount stated in the annual report filed with the TRA.
3. Determine the highest rate for pole attachments/conduit that MLGW charges comparable persons or entities for pole attachments.
4. Determine whether existing records of MLGW are maintained in a manner allowing for sufficient audit in this area.
5. Report findings.

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OBJECTIVE III. Pursuant to Tenn. Code Ann. § 7-52-403, determine whether the interest costs for funds lent to the Telecommunications Division by MLGW to acquire, construct, and provide working capital for the system, plant and equipment are allocated at a rate not less than the highest rate earned by MLGW on invested electric plant funds.

PROCEDURES

1. Obtain copies of all loan agreements between MLGW and the Telecommunications Division between August 2001 and December 2002.
2. Review general ledger to verify amount of loan, interest expense, accrued interest...
3. Determine effective interest rate on each loan made by MLGW to the Telecommunications Division.
4. Obtain from audited financial statements, the rate MLGW earned on invested electric plant funds during the loan period.
5. Compare rates of interest for loans to the Telecommunications Division with rates earned by MLGW on its invested electric plants funds.
6. Determine whether existing records of MLGW are maintained in a manner allowing for sufficient audit in this area.
7. Report findings.

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OBJECTIVE IV. Determine whether MLGW and Memphis Networkx have separate employees.

PROCEDURES

1. Obtain payroll ledgers, inclusive of employee names and social security/employee identification number, for MLGW and Memphis Networkx for the period August 2001 through December 2002.
2. Cross reference employee names and social security/employee identification numbers to determine whether separate employees have been maintained.
3. Obtain from management a detailed explanation for anyone simultaneously employed by MLGW and Memphis Networkx.
4. Determine whether existing records of MLGW and Memphis Networkx are maintained in a manner allowing for sufficient audit in this area.
5. Report findings.

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OBJECTIVE V. Develop a detailed understanding of the relationship between Allied Utility Network LLC (acting as participating utility on behalf of MLGW), LecStar and determine the effect, if any, on the operations of Memphis Network.

PROCEDURES

1. Obtain a copy of all contracts entered into between Allied Utility Network LLC and LecStar in effect between August 2001 and December 2002.
2. Discuss with MLGW the general relationship of these contracts and the effects that said contracts have on the Telecommunications Division of MLGW.
3. Discuss with MLGW whether any revenues or expenses have been allocated to the Telecommunications Division as a result of these contracts. If so, determine whether the allocation methodology is reasonable and consistent with MLGW's cost allocation manual.
4. Determine whether existing records of MLGW are maintained in a manner allowing for sufficient audit in this area.
5. Report findings.

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OBJECTIVE VI. Determine whether common costs of MLGW have been properly allocated to its Telecommunications Division.

PROCEDURES

1. Obtain a copy of the annual report filed with the TRA by MLGW for the period August 2001 through December 2002.
2. Verify total amount of common costs for MLGW via MLGW's general ledger for the period August 2001 through December 2002.
3. Verify the amount of common costs allocated to the Telecommunications Division with the amount stated in the annual report filed with the TRA.
4. Obtain from MLGW the approach and rationale used in determining the method for allocating common costs to the Telecommunications Division.
5. Determine whether approach for allocating common costs is reasonable and otherwise consistent with MLGW's cost allocation manual.
6. Obtain the detailed calculations used in determining the amount of common costs allocated to the Telecommunications Division.
7. Verify calculations.
8. Determine whether existing records of MLGW are maintained in a manner allowing for sufficient audit in this area.
9. Report findings.

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OBJECTIVE VII. Determine whether labor costs of MLGW have been properly allocated to its Telecommunications Division.

PROCEDURES

1. Obtain a copy of the annual report filed with the TRA by MLGW for the period August 2001 through December 2002.
2. Verify total amount of labor costs for MLGW via MLGW's general ledger for the period August 2001 through December 2002.
3. Verify the amount of labor costs allocated to the Telecommunications Division with the amount stated in the annual report filed with the TRA.
4. Obtain from MLGW the approach and rationale used in determining the method for allocating labor costs to the Telecommunications Divisions.
5. Determine whether approach for allocating labor costs is reasonable and otherwise consistent with MLGW's cost allocation manual.
6. Obtain the detailed calculations used in determining the amount of labor costs allocated to the Telecommunications Division.
7. Verify calculations.
8. Determine whether existing records of MLGW are maintained in a manner allowing for sufficient audit in this area.
9. Report findings.

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OBJECTIVE VIII. Determine whether legal costs of MLGW have been properly allocated to its Telecommunications Division.

PROCEDURES

1. Obtain a copy of the annual report filed with the TRA by MLGW for the period August 2001 through December 2002.
2. Verify total amount of legal costs for MLGW via MLGW's general ledger for the period August 2001 through December 2002.
3. Verify the amount of legal costs allocated to the Telecommunications Division with the amount stated in the annual report filed with the TRA.
4. Obtain from MLGW the approach and rationale used in determining the method for allocating legal costs to the Telecommunications Division.
5. Determine whether approach for allocating legal costs is reasonable and otherwise consistent with MLGW's cost allocation manual.
6. Obtain the detailed calculations used in determining the amount of legal costs allocated to the Telecommunications Division.
7. Verify calculations.
8. Determine whether existing records of MLGW are maintained in a manner allowing for sufficient audit in this area.
9. Report findings.

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OBJECTIVE IX Determine whether travel costs of MLGW have been properly allocated to its Telecommunications Division.

PROCEDURES

1. Obtain a copy of the annual report filed with the TRA by MLGW for the period August 2001 through December 2002.
2. Verify total amount of travel costs for MLGW via MLGW's general ledger for the period August 2001 through December 2002.
3. Verify the amount of travel costs allocated to the Telecommunications Division with the amount stated in the annual report filed with the TRA.
4. Obtain from MLGW the approach and rationale used in determining the method for allocating travel costs to the Telecommunications Division.
5. Determine whether approach for allocating travel costs is reasonable and otherwise consistent with MLGW's cost allocation manual.
6. Obtain the detailed calculations used in determining the amount of travel costs allocated to the Telecommunications Division.
7. Verify calculations.
8. Determine whether existing records of MLGW are maintained in a manner allowing for sufficient audit in this area.
9. Report findings.

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OBJECTIVE X. Determine whether costs relating to Horrell Communications have been properly allocated by MLGW to its Telecommunications Division.

PROCEDURES

1. Obtain a copy of the annual report filed with the TRA by MLGW for the period August 2001 through December 2002.
2. Verify total the amount of costs related to Horrell Communications for MLGW via MLGW's general ledger for the period August 2001 through December 2002.
3. Verify the amount of costs of Horrell Communications allocated to the Telecommunications Division with the amount stated in the annual report filed with the TRA.
4. Obtain from MLGW the approach and rationale used in determining the method for allocating costs related to Horrell Communications to the Telecommunications Division.
5. Determine whether approach for allocating costs related to Horrell Communications is reasonable and otherwise consistent with MLGW's cost allocation manual.
6. Obtain the detailed calculations used in determining the amount of costs allocated relating to Horrell Communications.
7. Verify calculations.
8. Determine whether existing records of MLGW are maintained in a manner allowing for sufficient audit in this area.
9. Report findings.

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OBJECTIVE XI. Determine whether administrative and general expenses of MLGW have been properly allocated to its Telecommunications Division.

PROCEDURES

1. Obtain a copy of the annual report filed with the TRA by MLGW for the period August 2001 through December 2002.
2. Verify total amount of administrative and general expenses for MLGW via MLGW's general ledger for the period August 2001 through December 2002.
3. Verify the amount of administrative and general expenses allocated to the Telecommunications Division with the amount stated in the annual report filed with the TRA.
4. Obtain from MLGW the approach and rationale used in determining the method for allocating administrative and general expenses to the Telecommunications Division.
5. Determine whether approach for allocating administrative and general expenses is reasonable and otherwise consistent with MLGW's cost allocation manual.
6. Obtain the detailed calculations used in determining the amount of administrative and general expenses allocated to the Telecommunications Division.
7. Verify calculations.
8. Determine whether existing records of MLGW are maintained in a manner allowing for sufficient audit in this area.
9. Report findings.

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OBJECTIVE XII. Determine whether any other expenses of MLGW have been allocated to its Telecommunications Division and, if so, determine the reasonableness of such allocation.

PROCEDURES

1. Review the general ledger to determine whether any other expenses have been allocated by MLGW to its Telecommunications Division for the period August 2001 through December 2002.
2. Obtain from MLGW the approach and rationale used in determining the method for allocating each expense identified in 1 above to the Telecommunications Division.
3. Determine whether approach for allocating these expenses is reasonable and otherwise consistent with MLGW's cost allocation manual.
4. Obtain the detailed calculations used in determining the amounts of these other expenses allocated to the Telecommunications Division.
5. Verify calculations.
6. Determine whether existing records of MLGW are maintained in a manner allowing for sufficient audit in this area.
7. Report findings.

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OBJECTIVE XIII. Determine whether MLGW has billed Memphis Networkx the appropriate tariff rates for electric services provided to Memphis Networkx.

PROCEDURES

1. Obtain copies of monthly bills rendered to Memphis Networkx by MLGW for electric services from August 2001 through December 2002.
2. Discuss with MLGW and obtain appropriate tariff rate schedule(s) applicable to Memphis Networkx for electric service.
3. Verify appropriate electric service rates were applied to Memphis Networkx.
4. Verify monthly amounts billed and collected for electric service to general ledger accounts and to the amount stated in the annual report filed with the TRA.
5. Determine whether existing records of MLGW are maintained in a manner allowing for sufficient audit in this area.
6. Report findings.

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OBJECTIVE XIV. Determine whether MLGW has billed Memphis Networkx the appropriate tariff rates for gas services provided to Memphis Networkx.

PROCEDURES

1. Obtain copies of monthly bills rendered to Memphis Networkx by MLGW for gas services from August 2001 through December 2002.
2. Discuss with MLGW and obtain appropriate tariff rate schedule(s) applicable to Memphis Networkx for gas service.
3. Verify appropriate gas service rates were applied to Memphis Networkx.
4. Verify monthly amounts billed and collected for gas service to general ledger accounts and to the amount stated in the annual report filed with the TRA.
5. Determine whether existing records of MLGW are maintained in a manner allowing for sufficient audit in this area.
6. Report findings.

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OBJECTIVE XV. Determine whether MLGW has billed Memphis Networkx the appropriate tariff rates for water services provided to Memphis Networkx.

PROCEDURES

1. Obtain copies of monthly bills rendered to Memphis Networkx by MLGW for water services from August 2001 through December 2002.
2. Discuss with MLGW and obtain appropriate tariff rate schedule(s) applicable to Memphis Networkx for water service.
3. Verify appropriate water service rates were applied to Memphis Networkx.
4. Verify monthly amounts billed and collected for water service to general ledger accounts and to the amount stated in the annual report filed with the TRA.
5. Determine whether existing records of MLGW are maintained in a manner allowing for sufficient audit in this area.
6. Report findings.

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OBJECTIVE XVI. Determine whether the amounts billed by MLGW to Memphis Networkx for non-tariffed services, specifically make ready work & engineering, are reasonable.

PROCEDURES

1. Discuss with MLGW and develop a general understanding of all non-tariffed services, and specifically the type of work associated with the make ready work and engineering, performed for Memphis Networkx.
2. Obtain all invoices/contracts, including underlying calculations, for all non-tariffed services billed by MLGW to Memphis Networkx from August 2001 through December 2002.
3. Verify invoice/contract amounts for all non-tariffed services with the general ledger and with the amounts stated in the annual report filed by MLGW with the TRA.
4. Verify labor costs for non-tariffed services performed with payroll registers.
5. Verify invoices for materials costs included for non-tariff services billed to Memphis Networkx by MLGW.
6. Verify other costs included in amounts billed to Memphis Networkx by MLGW for non-tariffed services.
7. Determine whether existing records of MLGW are maintained in a manner allowing for sufficient audit in this area.
8. Report findings.

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OBJECTIVE XVII. Determine whether any revenues of MLGW have been allocated to its Telecommunications Division and, if so, determine the reasonableness of the allocation.

PROCEDURES

1. Review the general ledger to determine whether any revenues have been allocated to by MLGW to the Telecommunications Division for the period August 2001 through December 2002.
2. Obtain from MLGW the approach and rationale used in determining the method for allocating the revenues identified in 1 above to the Telecommunications Division.
3. Determine whether approach for allocating these revenues is reasonable and otherwise consistent with MLGW's cost allocation manual.
4. Obtain the detailed calculations used in determining the amounts of these revenues allocated to the Telecommunications Division.
5. Verify calculations.
6. Determine whether existing records of MLGW are maintained in a manner allowing for sufficient audit in this area.
7. Report findings.

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PROCEDURES FOR SUBSEQUENT EVENTS

1. Inquire of management whether processes and procedures in place during the engagement period for ensuring compliance with statutory and Authority requirements have changed subsequent to the engagement period. If so, re-perform the related procedures to determine continued compliance with those requirements. Disclose and report the results of procedures re-performed.
2. Inquire and obtain written representation from management as to whether any events have occurred subsequent to the engagement period, but prior to the issuance of the report, which may affect compliance with any of the objectives described herein. Disclose any such event.